<u>Editor's Note:</u> Appealed – Civ. No. CV-95-142-GF-PGH (D. Mt. Dec. 26, 1995); <u>dismissed</u> (March 18, 1997), <u>appeal filed</u>, No. 97-35517 (9th Cir. May 16, 1997), <u>stipulated</u> <u>dismissal</u>, (Dec. 22, 1998).

XENO, INC.

IBLA 92-501 Decided November 14, 1995

Appeal from a decision of the Director, Minerals Management Service, affirming an order of the Denver Royalty Compliance Division assessing additional royalties. MMS-89-0189-O&G.

Vacated and remanded.

1. Federal Oil and Gas Royalty Management Act of 1982: Royalties--Oil and Gas Leases: Royalties: Generally

Under the "gross proceeds" rule the value of production for royalty purposes shall never be less than the gross proceeds accruing to the lessee from the sale thereof. The sale price received by an affiliate of the lessee in the first arm's-length transaction is properly considered in determining the value of produced gas under the gross proceeds rule.

2. Federal Oil and Gas Royalty Management Act of 1982: Royalties--Oil and Gas Leases: Royalties: Generally

Under the "marketable condition" rule royalty is due on the gross proceeds accruing to the lessee including payments for the cost of measuring, gathering, and compressing gas where such services are necessary to place the gas in marketable condition. Deductions from the value of the gas for these expenses are not allowed whether incurred by the lessee or a third party, before or after the initial sale of the gas, when the evidence discloses this is necessary to market the gas.

3. Federal Oil and Gas Royalty Management Act of 1982: Royalties--Oil and Gas Leases: Royalties: Generally

When gas is valued at a point downstream from the wellhead where the value of production is ordinarily determined, allowances are generally required for expenses (other than those required to put the gas in marketable condition) which add to the value of the gas after production. Valuation of gas properly considers the price received in the first arm's-length sale, but an assessment based on such a valuation will be vacated and remanded when the record shows that it failed to consider transportation costs reflected in the sale price.

APPEARANCES: L. Poe Leggette, Esq., Washington, D.C., and Lawrence E. Glenn, Esq., Houston, Texas, for appellant; Howard W. Chalker, Esq., Peter J. Schaumberg, Esq., and Geoffrey Heath, Esq., Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE GRANT

Xeno, Inc., has appealed from a decision of the Director, Minerals Management Service (MMS), dated March 19, 1992, upholding an order of the Denver Royalty Compliance Division, MMS, assessing additional royalties. That order, dated May 15, 1989, held that appellant had underpaid royalties in the amount of $291,286.66 on natural gas produced and sold from 12 Federal oil and gas leases during the period January 1982 through December 1986. 1/ This underpayment occurred, MMS found, because Xeno improperly deducted gathering and compression charges when calculating and paying royalties due.

Appellant was the operator of the 12 Federal oil and gas leases in question located in Blaine County, Montana, approximately 15 miles from the Canadian border. On July 24, 1986, the Battle Creek producing area was designated as a "field" for State regulatory purposes by the Board of Oil and Gas Conservation, State of Montana. During the 1982-1986 audit period, this general area consisted of 106 fee leases, 2 State leases and 12 Federal leases. During the audit period there were 27 to 33 producing wells in the Battle Creek area (Appellant's Statement of Reasons (SOR) at 7). 2/

1/ These leases were identified as follows:

154-010158-0	154-021743-A	154-035409-0
154-015946-0	154-021743-B	154-035410-0
154-017677-0	154-021743-C	154-036579-0
154-020856-0	154-021743-0	154-037132-0

2/ The briefs and exhibits filed by the parties to this appeal have been substantial and detailed, as well as numerous. Appellant has filed a SOR for appeal, a reply brief, and a second reply brief. Counsel for MMS has filed an answer and a response to Xeno's reply brief. The regulations governing appeals before the Board are silent regarding the right to file briefs other than a statement of reasons for appeal and an answer to appellant's statement of reasons. See generally 43 CFR 4.412(a); 43 CFR 4.414 (time to file a statement of reasons and time to file an answer). In the exercise of its discretion, this Board has occasionally granted leave to

Some of the lessees in the Battle Creek area formed a joint venture, the Battle Creek Gas Gathering System (BCGGS), to purchase gas at the wellheads and resell the gas to Montana Power Company (Montana Power or MPC) at a common delivery point on Montana Power's pipeline (SOR at 3). In August 1978, the lessees entered into a fifteen-year gas purchase contract with BCGGS for the sale of gas produced in the area. The lessees' contract specified an initial price of $1.75 per Mcf subject to adjustment in relation to changes in the price payable under the terms of the BCGGS-Montana Power contract. Title to the gas produced and sold was transferred from the lessees to BCGGS at the various wellheads. Lessees paid royalties on the gross proceeds received by the lessees at the wellhead under the contract with BCGGS.

Pursuant to section 205 of the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA), 30 U.S.C. § 1735 (1994), the State of Montana reviewed Xeno's royalty payments from the leases and found that Xeno underpaid royalties from the leases. This asserted underpayment was due to the fact that Xeno had valued the lease production for royalty purposes at the wellhead price received from BCGGS rather than at the value established in the arm's-length contract between BCGGS and Montana Power. MMS reviewed Montana's determination and concurred with its findings. By order dated May 15, 1989, MMS ordered Xeno to pay $291,286.66 3/ in additional royalties for the period January 1982 through December 1986. The May 1989 MMS order found that the sale of the gas by Xeno to its affiliate BCGGS was not an arm's-length transaction and, thus, reference to the Montana Power sale price was necessary to value the produced gas. Further, the May 1989 MMS order held that the sole service performed by BCGGS was the gathering and compression of the produced gas and that the value of the gas may not be reduced by the cost of gathering and compressing the gas to put it in marketable condition. Hence, the MMS order held that the gas was properly valued at the price paid by Montana Power to BCGGS.

The Director's decision of March 19, 1992, which upheld the order of the Denver Royalty Compliance Division, relied in part on the regulation at 43 CFR 3162.7-1(a). This rule provides: "The operator shall put into marketable condition, if economically feasible, all oil, other hydrocarbons, gas, and sulphur produced from the leased land." The Director noted that it is well established that the operator of Federal leases is obligated to market production from the leases without deduction of compression

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fn. 2 (continued)
file a reply or responsive brief where it appears that such a brief might be of assistance in resolving the issues before the Board and the interests of the public and the parties would not be prejudiced by any consequent delay. Applying this criteria to the context of the present case, such leave is granted in this case.

3/ The assessment for additional royalties due was subsequently recalculated as noted in the Director's decision to a total of $291,908.18.

costs, citing the Geological Survey Conservation Division 4/ Manual (CDM), which states at section 647.2.3A: "The lessee is obligated to place lease production in marketable condition without deduction of costs for measuring, compressing, or otherwise conditioning the gas for market." The Director also referred to language in Notice to Lessees (NTL)-1 which reads: "No deduction will be allowed for the cost which an operator incurs by reason of placing the gas in a marketable condition as an operator is obligated to do so at no cost to the lessor." 42 FR 4546, 4548 (Jan. 25, 1977). Similar language is found in NTL-5, the Director pointed out, which reads: "Likewise, no deductions will be allowed for the uncompensated cost of placing the gas into marketable condition." 42 FR 22610, 22611 (May 4, 1977). 5/

The Director responded to Xeno's argument that because the gas is sold at the wellhead to BCGGS, it is "marketable" at that point, and that any costs subsequently incurred in the gathering and compression of that gas downstream from the point of sale should not be regarded as "marketing costs." The Director rejected this argument, finding that Xeno's sales to BCGGS reflect a deduction from the sales price to compensate BCGGS for the costs of compression and gathering and that the proceeds received by the lessees in the sale of the subject gas are directly diminished by those costs. The Director stated: "Whether the gathering and compression was performed prior to or after the sale of the gas to BCGGS is irrelevant. The real question is whether those marketing costs have been charged against the Government's royalty share. I find that they have" (Director's Decision at 4).

On appeal Xeno contends that the correct value for the gas for royalty purposes is the wellhead volume multiplied by the gross proceeds received by the lessees at the wellhead under the sale contract to BCGGS. Xeno asserts that the gross proceeds received by the lessees at the wellhead constitute "reasonable value" when compared to the prices being paid in northern Montana for the majority of like-quality gas (SOR at 11-14). See Exhs. M, N, P, Q, and 1. 6/ Appellant emphasizes that the lessees were paid a higher price by BCGGS at the wellhead than other producers who sold

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4/ Prior to creation of MMS, royalty collection was the responsibility of the Conservation Division of Geological Survey within the Department of the Interior. MMS was created by Secretarial Order No. 3071 (Jan. 19, 1982). 47 FR 4751 (Feb. 2, 1982). Matters relating to royalty and mineral revenue management were subsequently transferred to MMS under Secretarial Order No. 3087 (Dec. 3, 1982). 48 FR 8983 (Mar. 2, 1983).

5/ NTL-1 and NTL-5 have been superseded and terminated effective Mar. 1, 1988. 30 CFR 206.150(e); 53 FR 1230, 1271 (Jan. 15, 1988).

6/ Xeno's exhibits designated by letter refer to the exhibits attached to Lessees' Brief in Response to Report and Recommendation of Royalty Compliance Division, dated Apr. 4, 1991. References to numbered exhibits are to exhibits in the appendix to appellant's SOR on appeal.

the majority of like quality gas in the area during the audit period (SOR at 38).

Appellant claims that the Director incorrectly determined that gathering and compression costs are necessary per se to place gas in marketable condition. Appellant asserts that the Director failed to consider whether the contract required the lessees to bring the gas to a central location and compress it to a specified pressure (SOR at 28-29). According to appellant, the gas was in marketable condition when it was sold at the wellhead without gathering or compression. Appellant supports its contention that the gas was marketable at the wellhead without gathering or compression by reference to offers made by companies other than BCGGS to purchase gas at the wellhead without gathering or compression (SOR at 33-34). Further, Xeno contends that during the audit period gas was produced at a sufficient pressure to deliver the gas through the BCGGS lines and the Montana Power pipeline to two towns which were consuming gas (SOR at 36, Exh. 1 at 7). Appellant asserts that the BCGGS "compressor was installed for the purpose of injecting gas into MPC's Box Elder storage facility" (Exh. 1 at 6). Xeno explains that the pipeline between the outlet of the compressor and the Box Elder storage field is approximately 24 miles long, the compressor raises the pressure in the storage reservoir during the summer, and during winter demand periods the compressor moves the gas through the pipeline directly to consumers. Id. Thus, appellant states that lessees' wells and the BCGGS compressor were the only significant source of gas and pressure flowing into the eastern end of Montana Power's pipeline (SOR at 52).

Further, appellant contends that the service performed by BCGGS qualified as "transportation," as distinguished from "gathering," noting that it occurred after the gas left the wellhead, the point of measurement for royalty purposes and the point where Xeno contends the market existed. Allowable transportation costs may be deducted in calculating royalties (SOR at 56-62). Appellant points out that during the audit period royalties were paid on the basis of the volume metered at the wellhead, but BCGGS sold 192,892 Mcf less gas to Montana Power due to unavoidable losses (SOR at 55). Further, Xeno notes that royalty is not generally payable on unavoidably lost gas. Id. Appellant also argues that the MMS decision requiring the payment of additional royalties is barred by the statute of limitations set forth at 28 U.S.C. § 2415 (1994).

In its answer filed November 17, 1993, MMS asserts that it complied with the regulations by valuing Xeno's gas based on the price received by BCGGS from Montana Power for gas in marketable condition. MMS explains that it may look beyond the sale of gas from Xeno to BCGGS to establish the value of the gas because that sale was a non-arm's length transaction. MMS notes that BCGGS is owned by Xeno and some of the other lessees in the Battle Creek field and, therefore, Xeno and BCGGS are affiliates. A sale between affiliates, MMS states, is not an arm's length sale (Answer at 4-

6). MMS asserts that Xeno cannot be permitted to reduce its royalty obligation by creating an affiliated company to market its gas, an obligation the lessee is required to perform at its own expense. Noting that the royalty valuation may not be less than the gross proceeds accruing to the lessee from the sale of production, MMS asserts that BCGGS performed no service other than moving the gas from the wellhead to the Montana Power pipeline. As this point of delivery is in the field where the gas is produced, MMS states that this expense would not be deductible from the sale price to Montana Power if the gathering were performed by Xeno itself. Id. at 8. The MMS Answer also asserts that the wellhead production pressure was at times less than the Montana Power pipeline pressure so that compression was required to market the gas into the pipeline. Id. at 9. 7/

It is contended by MMS that the higher price for the gas paid by Montana Power (as opposed to the price paid by BCGGS) reflects a greater value of the gas and that all or part of the difference is due to the effort of Xeno and BCGGS to place the gas in marketable condition (Answer at 8-9). MMS acknowledges that Xeno is entitled to subtract its actual transportation costs, if any, from the sale value of the gas at the Montana Power interconnect (Answer at 16). In its answer MMS suggests that the Board order Xeno to provide data documenting transportation costs which it or Battle Creek may have incurred. If Xeno substantiates its claims of transportation costs, MMS states that the Board could then remand the case to MMS for consideration of the documentation and issuance of a decision (Answer at 16-17). 8/ In its response, MMS recognizes that some of the expenses associated with the BCGGS gathering pipeline system may constitute allowable transportation costs as the distance from the leasehold to the point of delivery increases (Response at 9 n.2). Similarly, MMS recognizes that appellant may be entitled to credits for fuel gas consumed in powering the BCGGS compressor and unavoidably lost gas if supporting documentation is provided (Answer at 17).

7/ Appellant disputed this assertion with supporting documentation in its reply brief.

8/ MMS had the opportunity to request this information directly from Xeno prior to issuance of the decision under appeal. The contention that costs associated with gathering and compression of the gas were not necessary to place the gas in marketable condition was made in Xeno's brief before the Director, MMS, in response to the report and recommendation of the royalty compliance division. Thus, appellant asserted that the gathering system was not a typical on-lease gathering system, but rather "part of the overall transportation system of Montana Power" (SOR at 3). Further, Xeno asserted that the wells at issue met the buyer's minimum requirements for pressure and reserve quantities without compression (SOR at 15). Unfortunately, no further information was obtained and the Director's decision did not discuss Xeno's assertion that in the context of the facts of this case the expenses of gathering and compression were transportation costs rather than costs of marketing the gas.

Further, MMS contends that the decision should be upheld on the basis that it was proper to look beyond the non-arm's-length sale to the price received by Xeno's affiliate (Response at 6). Specifically, MMS asserts that the price received by the affiliate in the first arm's-length sale is a relevant factor in valuation of the gas under the regulation at 30 CFR 206.103 (1987). Id. at 6-7. Finally, MMS contends that the royalty valuation methodology is in accordance with the regulations and, hence, is not "plainly erroneous" and must be upheld. 9/

With respect to Xeno's assertion that the claim for additional royalties is barred by the statute of limitations, we note that the Board has examined similar contentions in the past and has consistently rejected them. Thus, the Board has repeatedly held that, while statutes of limitations may apply to judicial enforcement of administrative actions, they are not applicable to the underlying administrative proceedings. See, e.g., Chevron U.S.A., Inc., 129 IBLA 151 (1994); Forrest Oil Corp., 111 IBLA 284 (1989). Accordingly, appellant's contention is rejected.

[1] The threshold issue raised by this case is whether MMS is authorized to look to the first arm's-length sale of the gas to determine value for royalty purposes. The relevant regulation for valuation of gas during the audit period provided in pertinent part:

> The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product * * * due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross

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9/ Although no authority is cited for the "plainly erroneous" rule, MMS does cite cases noting that when valuation of production is challenged appellant must not merely show that the methodology is susceptible to error, but show that error occurred. See Phillips Petroleum Co., 109 IBLA 4, 7 (1989). The origin of this line of precedent goes back to Supron Energy Corp., 55 IBLA 318 (1981). In that case the Board noted that appellant had failed to show that the apparent reliance on a valuation standard which could have been different from that stated in the relevant regulation resulted in an improper valuation. 55 IBLA at 321-22. Unlike Supron in which we refused to speculate on the possibility of error in valuation which had not been shown, the issue in the case before us is whether the record supports the MMS valuation in view of specific errors which have been asserted.

> proceeds accruing to the lessee from the sale thereof * * *. [Emphasis added.]

30 CFR 206.103 (1987). 10/ The latter portion of the above-quoted regulation is often referred to as the "gross proceeds" rule. This rule has been held to justify valuation of gas produced in Alaska on the basis of the proceeds of the first arm's-length sale of the gas in Japan with allowances for the costs of liquefaction and transportation to calculate the net back to the lessee. Marathon Oil Co. v. United States, 604 F. Supp. 1375, 1381-86 (D. Alaska 1985), aff'd, 807 F.2d 759 (9th Cir. 1986), cert. denied, 480 U.S. 940 (1987). This Board has also held that the sale price received by an affiliate of the lessee in the first arm's-length transaction is properly considered in determining the value of gas produced under the gross proceeds rule. Shell Oil Co. (On Reconsideration), 132 IBLA 354 (1995), overruling, Shell Oil Co., 130 IBLA 93 (1994); see Santa Fe Energy Products, Co., 127 IBLA 265 (1993). It appears that there was an economic benefit to the lessees from formation of the joint venture to undertake delivery of the gas to Montana Power. The record indicates that from January 1982 through the end of the audit period the price of gas paid by BCGGS was higher than the wellhead price paid by Montana Power (Exh. M, Exh. 1 at ¶ 14). Thus, under the gross proceeds rule, consideration of the price received by BCGGS on sale of the gas was reasonable. 11/

10/ The Department has revised the rules applicable to the valuation of oil and gas for royalty purposes. Effective Mar. 1, 1988, the Department removed 30 CFR 206.103 (1987) and revised 206.102 to govern valuation standards. 53 FR 1184, 1218, 1220-21 (Jan. 15, 1988).

11/ Xeno's contention that we are precluded from considering the gross proceeds rule in reviewing this case because this was not relied upon by the Director in his decision is to no avail. It is well established that:

"The Secretary, as chief executive officer of the Department with full supervisory powers, has plenary authority to review de novo all official actions and to decide appeals from such actions on the basis of a preponderance of the evidence in cases involving substantive rights, or on the basis of public policy or public interest in cases involving the exercise of discretion. Act of March 3, 1849; 9 Stat. 395. The Secretary's inherent authority in this regard may not be diminished or constrained by those whose only authority derives from the delegated powers of the Secretary. Therefore, the scope of appellate review by or on behalf of the Secretary can be so limited only by the Secretary himself in a duly promulgated regulation, or by the Congress through enacted law. No such restraint on the scope of agency review has been imposed in cases such as this one. Therefore, the Board has a duty to consider and decide them 'as fully * * * as might the Secretary.' 43 CFR 4.1."

United States Fish & Wildlife Service, 72 IBLA 218, 220-21 (1983) (footnote omitted).

However, this does not conclude the inquiry into the proper valuation of production for royalty purposes. When gas is valued at a point downstream from the wellhead where the value of production is ordinarily determined, allowances are generally required for the value added to the gas after production. See Marathon Oil Co. v. United States, supra. Thus, for example, where there is no market in the field, a transportation allowance is ordinarily allowed for conveying production to the first available market. See Petro-Lewis Corp., 108 IBLA 20, 35, 96 I.D. 127, 135 (1989); Kerr-McGee Corp., 22 IBLA 124, 128 (1975).

[2] An exception, however, is made for the costs of placing the gas in marketable condition. Under the "marketable condition rule" royalty is due on the gross proceeds accruing to the lessee including payments for the cost of measuring, gathering, and compressing gas where such services are necessary to place the gas in marketable condition. Mesa Operating Ltd. v. U.S. Department of the Interior, 931 F.2d 318, 323 (5th Cir. 1991). It is well recognized in the Department that a Federal oil and gas lessee is under an obligation to assume the expenses of marketing any gas produced from the leasehold. The Texas Co., 64 I.D. 76, 79 (1957). 12/ In that case the lessee agreed to deliver its gas for sale at a certain pressure at a central point in the field. Since the lessee operated only two wells in a much larger field, it contracted with Humble Oil, the operator of gathering pipelines and compressor stations, to transport the low-pressure gas from appellant's separator at the wellhead to the point of market at the pipeline and to compress the gas to the pressure required for entry into the buyer's pipeline. The lessee sought to deduct the costs charged by Humble for gathering and compressing the gas. In rejecting appellant's contention that lessee's duty was limited to marketing the low-pressure gas at the wellhead thus entitling the lessee to deduct the cost of transporting the gas to the point of market in the field and placing the gas in such condition that it can enter that market, the Department distinguished transportation allowances from the costs of placing produced gas in marketable condition:

> The situation presented here is not comparable to the situations * * * wherein the cost of transportation was said to be allowable. In those cases there was no market in the field for the product and the lessee had to transport the product elsewhere in order to market it. Here a market for oil

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12/ The duty of the Federal lessee to market the gas was held to be clearly spelled out in the regulation at 30 CFR 221.35 (1959) requiring the lessee to avoid waste of gas and to either market it, consume it beneficially, or return it to the producing formation. 64 I.D. at 79. A similar requirement is found in the operating regulations currently in effect which mandate that: "The operator shall put into marketable condition, if economically feasible, all oil, other hydrocarbons, gas, and sulphur produced from the leased land." 43 CFR 3162.7-1(a).

> well gas exists in the Duck Lake Field and the cost of gathering the gas from the wells and transporting it to the point of sale in the field is deemed to be one of the ordinary incidents of lease operation.

64 I.D. at 79-80. This rule of not allowing deduction of costs of gathering and compression of the gas for delivery at a point in the field when required pursuant to the sale contract has been upheld in subsequent cases. Kerr-McGee Corp., 22 IBLA 124 (1975); The California Co., 66 I.D. 54 (1959), aff'd, 187 F. Supp. 445 (D.D.C. 1960), aff'd, California Co. v. Udall, 296 F.2d 384 (D.C. Cir. 1961). 13/ Further, the fact that compression takes place after the gas has entered the buyer's pipeline does not alter this result where such compression is required as a condition of sale. Big Piney Oil & Gas Co., A-29895 (July 27, 1964). In upholding the Department's position, the court in California Co. v. Udall, supra, noted that: "In the record before us there is no evidence of a market for the gas in the condition it comes from the wells. The only market, as far as this record shows, was for this gas at certain pressure and certain minimum water and hydrocarbon content." 296 F.2d at 388, quoted in Big Piney Oil & Gas Co., supra.

We have also applied the marketable condition rule in cases where the gas was sold at the wellhead, after initial compression, to the operator of a low pressure field gathering system who further compressed the gas as necessary to introduce the gas into a market pipeline. The royalty valuation of production at a price reduced from the sale price to the pipeline company by the costs of gathering the gas from various wellheads and compressing it to the pressure necessary to enter the pipeline has been disallowed:

> Whether the lessee assumes the expense of gathering and compression himself or pays a third party to perform this function for him, the cost is an obligation of the lessee. Further, it makes no difference whether the lessee transfers title to the gas at the wellhead separator for a price reflecting a reduction from the market price by the amount of the gathering and compression costs or whether the lessee retains title and pays a contractor to undertake this function. Case law clearly establishes that Yarbrough's sale of gas to NGO does not compel a finding that the gas was in marketable condition at the time of sale. Big Piney Oil & Gas Co., A-29895 (July 27, 1964) (compression and gathering costs incurred after sale of gas to operator of gathering system

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13/ The court found that gas conditioned for market was gas that satisfied market specifications for water content, liquefiable hydrocarbons, and compression, such as those set forth in the sales contract of California Company. 296 F.2d at 388.

> were not deductible); Placid Oil Co., 70 I.D. 438 (1963) (transfer of title did not alter nondeductibility of certain expenses incurred thereafter); cf. Arco Oil & Gas Co., 109 IBLA 34 (1989) (the point of first "sale" is generally an indicium of the existence of a market, but the transfer of title to oil at an offshore platform may not establish a market at that point where the oil was subsequently transported to market by pipeline and held for the account of the producer).

R. E. Yarbrough & Co., 122 IBLA 217, 221 (1992). Similarly, in Beartooth Oil & Gas Co., 122 IBLA 267 (1992), 14/ we noted that:

> Appellant's sales contract expressly provides for a deduction from the sales price to compensate Mesa for the costs of compression, the Director found, and the proceeds received by Beartooth upon sale are directly diminished by these costs. Even if the marketing costs in dispute are Mesa's and not appellant's, it is clear that Mesa has passed those costs on to appellant in the form of a deduction from the gas sales price, the Director stated. The fact that a lessee, in effect, pays the purchaser to compress the gas by accepting a reduction in the sales price does not alter the rule that the lessee cannot reduce the royalty value by the cost of compressing the gas (Director's Decision at 3-4).

122 IBLA at 269.

[3] Concluding that the sole service provided by BCGGS was the gathering and compression of the produced gas to put it in marketable condition, MMS held it was justified in valuing the gas at the price paid by Montana Power. However, the record reflects no analysis of what constitutes marketable condition in the context of gas produced in the field at issue. Appellant has provided substantial evidence that the gas was in marketable condition at the time it was sold to BCGGS. Although the contract with BCGGS, an affiliated firm, is not itself persuasive regarding the marketable condition of gas at the wellhead, appellant has introduced other evidence. It appears from the record that, following completion of the discovery well in the field in 1977, the lessees

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14/ Vacated and remanded, Beartooth Oil & Gas Co. v. Lujan, CV 92-99-BLG-RWA (D. Mont. Sept. 22, 1993). The court held in part that the Board erred in applying the marketable condition rule without considering the conditions under which gas will be accepted by a purchaser under a sale contract typical for the field or area. Slip op. at 4. On remand, the parties filed a joint motion to dismiss the case on the ground they had reached an agreement to compromise and settle all issues raised in this case. The motion was granted by order of the Board. Beartooth Oil & Gas Co. (On Judicial Remand), IBLA 94-461 (May 9, 1995).

negotiated to market the gas from the field with numerous firms and that competing offers to purchase the gas at the wellhead were made by Montana Power, an intrastate pipeline company, and Northern Natural Gas, an interstate pipeline company (Exh. 1 at ¶¶ 9, 10). Montana Power would have bought the gas at the wellhead at $1.75 per Mcf or at a new point of delivery into their pipeline at $2.16 per Mcf. Id. at ¶ 10, Exh. I. 15/ In applying the case law to the present appeal, it appears that the situation is distinguishable in certain key respects from the precedents where the marketable condition rule was applied. In this case, unlike The Texas Co., supra, the lessee was not required to deliver the gas to the Montana Power pipeline to market the gas. Unlike the record in California Co. v. Udall, supra, there is evidence of a market for the gas at the wellhead. The existence of a market for the uncompressed gas at the wellhead provided by more than one pipeline company, as contrasted with a sale to a firm established for the sole purpose of putting the production in marketable condition, distinguishes the present case from Yarbrough and Beartooth where the gathering costs were disallowed. While the cost of gathering 16/ gas from the wellhead and moving it to a nearby delivery point in the field has been disallowed as a cost required to place the production in marketable condition where the lessee is obligated to do so under the sale contract, the evidence shows that in this case the gas is in marketable condition at the wellhead.

With respect to the distinction between gathering and transportation costs, we note that the CDM 17/ provided that generally a lessee may not deduct the cost of transporting gas "to the point of delivery specified in a contract, when that point of delivery is in the field where the lessee's well is located." CDM 647.5 3D (Release No. 11, May 10, 1974).

15/ The latter price corresponds to the price initially paid by Montana Power to BCGGS in September 1978 (Exh. M).
16/ While the regulations in effect at the time of the audit period did not define the term "gathering," the current regulations provide that: "Gathering means the movement of lease production to a central accumulation and/or treatment point on the lease, unit or communitized area, or to a central accumulation or treatment point off the lease, unit or communitized area as approved by BLM * * * operations personnel * * *." 30 U.S.C. § 206.151 (1994) (emphasis in original.) Xeno points out that lessees' production was measured and sold on the lease and that no authorization was obtained by the lessees for the accumulation of production offlease.
17/ The provisions of the CDM are properly distinguished from regulations promulgated pursuant to rulemaking provisions of the Administrative Procedure Act, 5 U.S.C. § 553 (1994), and, unlike regulations, do not have the force and effect of law and, thus, are not binding upon the Board. Mobil

Although the lessees' sale contract in this case providing for delivery of production at the wellhead is to an affiliated firm, the CDM provided further guidance. The CDM recognized that "pipeline gathering charges may be allowed [as transportation deductions] if (1) they are reasonable; (2) they are levied by a purchaser to a number of leases over a broad area; and (3) the net price received by the lessee is the highest net price paid for a majority of like quality production in the field or area." Id. The record in the present case indicates that a uniform wellhead price for production was offered to the lessees in the Battle Creek Field by Montana Power and subsequently provided to all lessees by BCGGS. See Exh. 1 at ¶¶ 10, 12. Further, there is evidence that the net price received by the lessee is the highest net price paid for a majority of like quality production in the field or area (Exh. 1 at ¶ 14, Exhs. N, N-1). Upon the evidence in this case, it appears that transportation of the produced gas from the wellhead to the point of delivery at the Montana Power pipeline was not required to place the gas in marketable condition. Rather, it appears that this cost is properly considered a transportation cost.

Regarding the costs incurred to compress the gas at the point of entry into the Montana Power pipeline, Xeno has provided evidence that the pressure of the gas from the wellheads was adequate to gain access to the pipeline market (SOR at 34, Exh. 1 at ¶ 18; Reply Brief at 12, Attachment A at ¶ 8). It appears from the record that the BCGGS compressor generates pressure in the Montana Power pipeline by pushing against closed valves on the outlet side of the storage reservoir approximately 24 miles distant (Exh. 1 at ¶ 19). The record shows that the compressor raises the pressure in the storage reservoir during the summer, and during winter demand periods the compressor moves the gas through the pipeline directly to consumers. Id. The evidence shows that: "Functionally, the BCGGS compressor serves as part of Montana Power's main line delivery system" (Exh. 1 at ¶ 17). Thus, the record before us does not support a finding that the costs of operating the BCGGS compressor are necessary to place the gas in marketable condition, but rather that the compressor is a transportation cost associated with delivery of the gas through the Montana Power pipeline to the consumer.

Accordingly, the record in this case does not support valuation of the gas at the price paid by Montana Power to BCGGS without allowances for value added to the gas prior to delivery. Similarly we find that calculation of the royalty obligation on the basis of the value of the gas delivered to Montana Power requires an allowance for gas unavoidably lost between the point of measurement at the wellhead and the point of delivery to Montana Power.

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fn. 17 (continued)
Producing Texas & New Mexico, Inc., 115 IBLA 164 (1990). Nonetheless, they frequently provide helpful guidance in the proper application of the regulations. See Beard Oil Co., 105 IBLA 285 (1988).

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision appealed from is vacated and the case is remanded.

C. Randall Grant, Jr.
Administrative Judge

I concur:

Gail M. Frazier
Administrative Judge